

TAXREP 7/00

INDIRECT TAXES AND E-COMMERCE

*Memorandum submitted in January 2000 by the Tax Faculty
of the Institute of
Chartered Accountants in England and Wales to the E-VAT
Forum (formerly the Electronic Commerce Consultation
Forum Consumption Taxes Sub-group)
in response to a request to suggest changes required to VAT
law
to tax supplies of services delivered electronically*

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INDIRECT TAXES AND E-COMMERCE

INTRODUCTION

1. We have prepared this paper for the E-VAT Forum at the request of HM Customs and Excise. It describes the changes to VAT law that we consider are required in order to tax supplies of services delivered electronically.
2. There are two major problems in applying VAT to such services along the lines proposed by the European Commission. The first is the absence of a common system for VAT in Europe. Changes to European Community VAT law must be agreed by all member states. The Commission's suggestion for a single registration for e-traders but without a clearing system is likely to be vetoed by Member States with high VAT rates. E-traders are unlikely to register in those countries and as a result the tax will not be collected in the Member State where consumption takes place. The second problem relates to collection and compliance. Non-EU traders will be expected to register in the EU. It is difficult to see how those outside the jurisdiction can be compelled to register and comply generally. There is a body of opinion that VAT may not be an effective way of taxing e-commerce until this issue can be resolved.
3. Notwithstanding these issues, the resolution of which is outside the scope of this paper, we set out below our proposals on how VAT might be used to tax e-commerce.
4. We do not think that major changes in VAT law are necessary. We set out in the Annex our suggested amendments to the Sixth VAT Directive. Quite apart from the threat to the revenue from e-commerce, there are some existing flaws in the Directive relating to the supply of services. Whilst we did not set out to deal with these flaws, our suggested amendments would deal with some of the shortcomings in the law relating to cross-border supplies of services.
5. In order to provide a focus to our work it was agreed that our starting point should be a number of principles for which there is some international agreement following the OECD conference in Ottawa last year. We have added two more principles, which will command general agreement.
6. The agreed guiding principles are:
 - (a) Digitised products should be taxed in the country of consumption.
 - (b) Digitised products should be treated as supplies of services.

- (c) Supplies of digitised products to the final consumer should be taxed in the country where the consumer has his usual place of residence.
- (d) There should be no new or additional taxes on digitised products other than VAT.

7. We propose the following additional principles:

- (a) The same rate of VAT should apply whether digitised products are purchased from a supplier established in the country of consumption or from a supplier established outside that country.
- (b) The means of delivery of the supply should make no difference to the amount of tax payable on the supply.

DETAILED COMMENTS

Registration

- 8. In the European Commission's working paper 'Indirect Taxes and E-Commerce' (XXI/99/1201-EN), the Commission departs from the first principle mentioned above, namely that digitised products should be taxed in the country of consumption. Instead the Commission merely proposes that services supplied for consumption within the European Union should be taxed within the EU and those supplied from within the EU for consumption outside the EU should not be subject to EU VAT.
- 9. The Commission's preferred option (described in its paper in the last sentence of para 4.1) will mean that suppliers of digitised products located outside the EU will be required to register in just one Member State and account to that state for all the VAT due on supplies to customers in all Member States. In the absence of a clearing system the Member State of registration will scoop the VAT pool and enjoy all the tax on supplies in every Member State.
- 10. Furthermore, if the supplier is established in one Member State and supplying digitised products to customers in other Member States, the country where the supplier belongs will benefit from VAT on final consumption all over the EU.
- 11. This single registration regime envisaged in the Commission's working paper is likely to be unacceptable to high VAT rate countries (we note in passing that the UK would benefit from the Commission's proposal in the short term because American suppliers are more likely to register in the UK than, say, Denmark, where the VAT rate is 25% and there are language difficulties). A system of charging tax by reference to the country of consumption

will have to be found. Also the tax should be accounted for to the tax authorities in that country.

- 12.** One way to bring about such a result would be to have a multi-registration regime for services delivered remotely, similar to the existing distance selling regime for goods. Against this, we agree with the Commission that excessive burdens of tax administration may promote a climate of non-compliance especially amongst traders not established in the EU.
- 13.** We are aware that the distance selling regime for goods is a flawed system. As with the Single Market transitional system generally there are existing problems of non-compliance with the regime and it is prone to fraud. We have pointed out to Customs a number of times in the last few years that the transitional regime is unsound for the reasons cited by the Commission: mainly because cross-border movements of goods take place VAT free. Checks on the system are so difficult to operate that widespread fraud could be occurring without the tax authorities being aware of it.
- 14.** Furthermore a multi-registration regime for services similar to the distance selling regime is much more complicated than the single registration arrangements suggested by the Commission. However, given the present slow pace of EU VAT harmonisation, this may be the only way forward until more progress is made towards completing the single market and the introduction of some type of clearing system for the allocation of taxes to the Member State where consumption takes place.
- 15.** One option explored by the Commission is to require non-EU operators to establish themselves in the EU. We think this is wrong. It is not appropriate for governments to dictate where foreign traders should establish businesses. Also any requirement to set up a business establishment within the EU would have consequences for direct tax, not just for VAT. This could have the effect of diverting tax revenue from the supplier's home country and it can be expected that the tax authorities of that country will raise objections.

Compliance

- 16.** The Commission's working paper recognises that there will be severe practical difficulties in enforcing compliance with VAT rules in respect of services provided by persons outside the jurisdiction of the EU. It is likely to be impossible to enforce any requirement that such persons should register for VAT or set up a business establishment within the EU.
- 17.** We question the strategy of introducing a regime without working out in advance how compliance can be enforced. No doubt some

reputable foreign traders will register even if there are no means of enforcement. It is likely that many non-EU traders will not. This will create distortions and put reputable traders at a competitive disadvantage. We think this risk is so serious as to discredit the whole proposal. Accordingly we recommend that some thought be given to enforcement whilst developing the proposed amendments to the law.

- 18.** Another difficulty of ensuring compliance is determining the usual place of residence of the final consumer. This is not as straightforward as it appears and yet it is crucially important to the regime envisaged by the Commission. A system, which relies on the supplier correctly determining the usual place of residence of his customer in order to collect the tax, is open to manipulation. For example, a customer of a non-EU supplier could simply give an address that is not his usual place of residence.
- 19.** There would be even greater difficulties in enforcing a requirement for private consumers to account for tax on imported services. We understand that certain countries outside the EU, for example Canada and Switzerland, have experimented with requiring private consumers who purchase services from outside the home jurisdiction to account for VAT on their income tax return. Whilst we have no detailed statistics on how successful this has been, we recommend that, in the interest of minimising tax leakage, private consumers should not be obliged to account for the tax.

VAT treatment

- 20.** Taxing remotely delivered services at the place of consumption would be in line with the treatment of goods supplied by mail order. Distortions would be eliminated if goods and services were taxed at the same rate. For example, if the VAT treatment of the supply of music depends on how it is delivered, this will create immediate and unacceptable distortions. Accordingly it will be necessary to ensure that music delivered via the Internet is taxed at the same rate as music delivered via tapes, compact discs or other formats regarded as goods. Ensuring that the same VAT rate applies for both goods and services does not require a change to the Directive. Nevertheless to avoid cross-border distortions within the EU it is important that Member States should agree this principle.

Goods

- 21.** Under the existing EU VAT regime, consumers can purchase goods tax paid in any Member State and if they move those goods to another Member State they are not subject to further taxation. In other words, tax is chargeable in the country where the goods are supplied and not, if different, where they are consumed. Understandably the Commission would not countenance a

withdrawal of this regime which is seen as a milestone on the route to completing the single market. However, this regime applies only to personal importations when it is applied to cross-border shopping for goods. If goods are bought by mail order, the tax charged is the rate ruling in the country where the goods are delivered, which will usually be where the consumer resides.

Services

- 22.** The treatment of services under the existing regime is different. Services supplied to a consumer in another Member State are taxed at the rate ruling in the country of the supplier. The rules in Article 9 (3) which charge tax based on the place where use and enjoyment takes place do not apply when supplies are made from one Member State to a consumer in another Member State. As a result VAT is not always charged in the country of consumption. This is contrary to the general principle that VAT is a tax on consumption to be charged where consumption takes place.
- 23.** Some services, such as the services supplied by hotels, are consumed where the hotel (i.e. the supplier) is situated. Also services such as performances by artistes are treated as supplied where they are physically carried out. In both of these examples the place where the supply is treated as taking place is also the place where the services are consumed.

Electronic delivery

- 24.** With this in mind, it would be more in keeping with the theme of the tax to charge VAT on services delivered remotely by reference to where the services are consumed. Services delivered remotely would include services delivered via the Internet, by telephone, by facsimile or by post and would include other services supplied where the customer is not present with the supplier during the whole of the time when the service is performed. For the sake of simplicity and effective administration it would make sense to treat services delivered remotely as consumed at the place where the consumer is usually resident.
- 25.** The use of electronic commerce simply highlights difficulties with the existing regime as described above. At present importations of services by final consumers resident in the European Union are often not taxed (perhaps because the Member State has not implemented Article 9(3)) or are taxed other than at the place of consumption. A solution to these problems should encompass the entire VAT system and should not be restricted to supplies delivered by electronic means.
- 26.** If electronically-delivered services are treated as a single and homogeneous category for VAT purposes it would not be possible to

comply with the principles stated above. In VAT law it is possible to apply a different treatment to different types of services. (Even that creates difficulties at the borderline between one type of service and another.)

27. Nevertheless, the tax treatment should be the same however the service is delivered. It would create distortions if supplies, which are fundamentally the same, were taxed differently depending on how they are delivered. For example it would be unacceptable if a UK resident consumer who imports legal services from Jersey were to be taxed differently depending on whether the service is supplied by letter mail or transmitted electronically.

Harmonisation

28. The imposition of a VAT charge on services received by EU private consumers from outside the EU in respect of electronic commerce services alone would create distortions. If the Commission is determined that such transactions should be liable to tax, then we believe that this should be imposed on a consistent basis across all services within the scope of VAT. This would require a wide-ranging review of the scope of the place of supply rules set out in article 9.
29. The failure by Member States to make more progress on the harmonisation of VAT rates across the EU could result in large distortions in trade as Internet shopping expands unless the VAT rules relating to services are changed. Traders belonging outside the EU might find it beneficial to set up in the EU country with the lowest VAT rate. As the tax loss becomes significant for high rate countries there will be pressure for a regime whereby traders are required to register in every country where they sell goods or services regardless of whether they are EU traders or traders who belong elsewhere.
30. If the place of supply was to be determined according to whether or not the customer was registered for VAT, care will need to be taken in verifying the VAT status. We believe that a central point of information access for VAT registration details is preferable to the current system of each Member State supplying information which appertains to its own registered persons. There are currently some difficulties which arise when information is requested. For example, when two or more persons are registered as a single entity, there can be confusion as to whether the appropriate identification number is that of the deemed single entity or something which applies to the particular part of it which is purchasing the goods or services.

Cost of collection

- 31.** It would be unfair to expect banks and credit card operators to provide the service of administering and collecting a withholding tax unless they were permitted to make a commercial charge for the service to the tax authority that benefits from the tax collected. It must be remembered that they have to collect and account for tax on their own supplies like other traders. They are in the business of supplying financial services and a withholding or similar tax on payments for digitised products would comprise the provision of a financial service to tax authorities.
- 32.** At present, credit/debit card issuers do not have the information to enable them to collect a withholding tax. The worldwide card system will need to be developed to enable card issuers to capture the necessary information. This will obviously take a considerable amount of time to initiate and involve considerable expense. The question of who is to meet the expense needs to be considered bearing in mind that not all card issuers will be involved in collecting a withholding tax.
- 33.** There are obstacles to passing the cost of collection to merchants because they may be resident outside the EU. Transaction costs of credit card transactions are met from a commission charged by the bank that is in contract with the merchant (known as the 'merchant acquiring bank'). Part of the commission is passed via the credit card clearer to the card-issuing bank. A typical example of services supplied via the Internet would be a supplier and a merchant acquiring bank both operating in the United States and a consumer and his card-issuing bank both based in the EU. If a withholding tax is a practical possibility, deciding who should pay for the costs of administering and collecting the tax is the next question. The problems are enormous. If they can be solved international agreement will be required before implementation.
- 34.** If the consumer and credit card user has to pay for the tax collection costs the effect will depend on how much it will cost. At present the consumer does not meet the transaction costs if he pays by credit card. If a charge is imposed to meet tax collection costs and it is significant it will promote the use of alternative means of payment and provide encouragement for tax evasion.
- 35.** Also it is not yet clear whether it is possible to devise a withholding tax that will work. There would be some formidable software problems as well as the difficulty of differentiating between transactions liable to VAT and those not and of identifying the rate of tax to be applied.

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SUGGESTED AMENDMENTS TO THE EU SIXTH VAT DIRECTIVE

Article 6

Supply of services

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.....

6(6) Supplies which are delivered electronically shall be regarded as supplies of services.

Article 9

Supply of services

1 (a) The place where services are supplied shall be deemed to be the place where they are consumed.

(b) Where services are received by a taxable person, the place of consumption shall be deemed to be where that person's business is established; where, however, that person has one or more fixed establishments in addition to the place where his business is established, the services shall be deemed to be supplied in the place of the establishment or fixed establishment which is most closely connected with the receipt of the supply.

(c) Where a taxable person does not have a place where his business is established, or any other fixed establishment, or where services are consumed by a person other than a taxable person, those services shall be deemed to be consumed where that person (the customer) has his usual place of residence.

2 However:

(a) Unchanged.....

(b) Unchanged.....

(c) Add the following words at the end
'or in the case of services delivered remotely the place where those services are consumed.'

(d) Existing (d) was deleted by Directive 84/386. New (d) added as follows:

'Services described in this paragraph received by a taxable person shall be treated in accordance with paragraph 1 (b) (new).

[(e) Deleted]

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Article 17

Origin and scope of the right to deduct

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(a) transactions relating to the economic activities referred to in Article 4(2), [~~carried out~~] *treated as supplied* in another country, which would be deductible if they had been [~~performed~~] *treated as supplied* within the territory of the country;

(b)

(c)

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